Congressman Ron Paul
July 23, 2002
Before the House Ways and Means Committee

Member comment period on HR 5095

MR. PAUL: Mr. Chairman, thank you for the opportunity to submit my statement regarding the corporate tax bill recently marked up by this committee.

I hope Congress understands the historical significance of this bill. Once again, as when we created the ETI ("extraterritorial") tax regime in 2000, we are acting at the behest on an international body. We are changing our domestic laws, and changing the way we tax domestic parent corporations on the activities of their subsidiaries operating wholly outside of the U.S., because an international body demands it. The WTO appellate panel has spoken, and their will trumps Congress. Yet we were assured in 1994 that our membership in the WTO would never diminish American sovereignty.

The Europeans argue, quite correctly, that we treat some foreign-source corporate earnings preferentially, i.e. we exempt from tax a portion of the earnings of foreign sales corporations (FSCs). This is not, however, an argument for abolishing the FSC-- it is an argument for adopting a territorial tax system like many of our European critics!

Putting politics aside, however, the reality is that we must craft a bill that satisfies the WTO to avoid further trade sanctions. While reform of our overall tax system remains an issue for another day, it is vital that Congress begin to consider comprehensive overhaul of U.S. international tax rules.

The FSC, created by Congress in 1984 under IRC sections 921-927, provides needed relief from the subpart F anti-deferral rules for the foreign subsidiaries of our domestic corporations. FSCs make it possible for U.S. corporations to better compete with companies incorporated in territorial-system nations-- which is to say companies that generally pay no corporate tax at all on the foreign-source income of their subsidiaries.

I urge the committee to reconsider repealing the FSC, an entity utilized by several corporations

in my district that employ thousands of people, including Marathon Oil, Dow Chemical, and British Petroleum. Since competing legislation recently introduced in this committee seeks to encourage American manufacturing and exports, it is imperative that any manufacturing deduction (for "qualified production activities") include income derived from the production of finished energy products-- refined gasoline, liquefied natural gas, etc.

It may not be possible to design a replacement that will replicate the same benefits (of the FSC) to the same taxpayers and still satisfy the WTO. On this point, I concur with Chairman Thomas. The committee should recognize that there will be winners and losers with any change to the existing rules. However, I believe it is important to balance the needs of various affected industries and implement any proposed legislation in a manner that avoids disruption of current business plans and activities.

Current international tax rules are grossly outdated. The basic Subpart F rules were enacted in 1962. These rules reflect the economic climate of that time. In 1962, the United States was a net exporter of capital and enjoyed a trade surplus. Imports and exports were only one-half of the percentage of GDP that they are today. The world has changed. Our tax laws need to change too.

The impact of U.S. tax rules on the international competitiveness of U.S. multinationals is much more significant an issue than it was forty years ago. Today, foreign markets provide an increasing amount of the growth opportunities for U.S. businesses. At the same time, competition from multinationals headquartered outside of the United States is becoming greater. Of the world's 20 largest corporations, the number headquartered in the United States has declined from 18 in 1960 to just 8 in 1996. Around the world, 21,000 foreign affiliates of U.S. multinationals compete with about 260,000 foreign affiliates of foreign multinationals.

If U.S. rules for taxing foreign source income are more burdensome than those of other countries, U.S. businesses will be less successful in global markets, with negative consequences for exports and jobs at home. I think a fair comparison of U.S. international tax rules and those of other nations shows that American businesses are increasingly put at a competitive disadvantage in the world marketplace.

First, about half of OECD countries have a territorial tax system under which a company generally is not subject to tax on the active income earned by a foreign subsidiary. By contrast, the United States taxes income of a U.S.-controlled foreign corporation either when repatriated

or when earned in cases where income is subject to U.S. anti-deferral rules.

Second, the scope of U.S. anti-deferral rules under subpart F is unusually broad compared to those of other countries. While some countries tax passive income earned by controlled foreign subsidiaries, the United States stands out for taxing (as a deemed dividend) a wide range of active income under various subpart F provisions.

Third, the U.S. foreign tax credit, which is intended to prevent double taxation of foreign source income, has a number of deficiencies that increase complexity and prevent full double tax relief.

Taken all together, you find that a U.S.-based business operating internationally frequently pays a greater share of its income in foreign and U.S. tax than does a competing multinational company headquartered outside of the United States. Yet Congress wonders why corporate inversions are at an all-time high!

One indication of the impact of an overly burdensome and complex tax regime on the U.S. economy is in the area of corporate mergers and reorganizations. U.S. international tax rules can play a key role in determining the location of a corporate headquarter, as we witnessed with the DaimlerChrysler merger. In fact, recent studies have shown that between 73 and 86 percent of large cross-border transactions involving U.S. companies have resulted in the merged company being headquartered abroad.

In conclusion, Mr. Chairman, I urge the committee to craft a final bill (or conference report) that satisfies the WTO without punishing those U.S. corporations that have relied on the FSC structure to maintain their international competitiveness. I also urge the committee to use this debate as a springboard for wholesale reform of our international tax rules.